Principle 3

Using favourable assessments

Introduction

For many centuries, a sovereign would only levy tithes. This was a tax in kind which led to constant tax evasion as a result of the underestimation of assets. House inventories were used as a basis for assessing and controlling tax.

As regards real estate, property tax was based for many years on rough surveys, and rare were assessments accurate.

By the middle of the 19th century, taxes were by and large still based on external signs or indications, rather than on a direct assessment of income. Searches were avoided to the extent possible, as they would have been contrary to the protection of emerging individual rights. To illustrate, let us cite the doors and windows tax created in *France* by the Directoire which could influence the architecture at that time.. In the United Kingdom, the hearth and chimney tax which was replaced in 1766 by a tax on house openings visible from the outside.

As modern taxation evolved, an attempt was made to levy tax on all income or the case being on wealth, even though this was difficult to calculate.

Contemporary taxation science uses both objective measuring criteria to correctly assess the nature of the taxable element, and time related criteria, which determines the time when assessment is due.

The value ascribed to any element of income or wealth is, nevertheless, the result of a subjective appreciation. Nowadays, a distinction is made between direct measures (assessing the taxable elements by mere calculation) and indirect measures (based on external indications determined by law). In practice, this often leads the tax authorities to tolerate an underestimate rather than risk an overestimate which would not prove acceptable. Several factors may result in underestimation, amongst which the most important is without doubt the difficulty to fix a market price; in actual fact, only the price of assets regularly traded on a free market can be easily determined. This does often not cover intellectual property (e.g. patent and author's rights or know how), nor some property charges and servitudes, agricultural or forestry assets, works of art and many more.

We shall examine in particular the case of the taxpayer involved in a barter deal (1.1). Income tax is not the only tax involved, since wealth factors can also be valued in the context of wealth, gift and inheritance tax (1.2). Finally, companies are also

affected by these issues (2). The taxpayer is obviously free to search for provisions and practices enabling him to benefit from advantageous assessments for all types of tax.

1. Individuals

1.1 Barter

The question of barter or trade-in may become extremely topical as telematics develop. It is likely that tools such as Internet will revolutionise our consumer habits by creating a true private market of goods and services traded by taxpayers.

It is true to say that barter does not generate any value at a macro-economic level : it relocates them. However, if we analyse individual needs, enrichment occurs when the object of the barter is more valuable, in the taxpayer's eyes, than what he can offer in exchange. Instead of selling what he can offer, and eventually incurring a taxable profit, or securing taxable income in order to obtain what he wants, he acquires it without any financial intermediary. This makes the assessment of the value extremely difficult. Moreover, in many cases, the exchange is not even reported to the tax authorities. Such practice may involve services or software. Given that software can be downloaded directly from the network, the tax authorities are bereft of any efficient controlling means in the levying of direct or consumption (VAT, custom duties) taxes.

In addition to barter, sales and purchases may also escape direct or indirect tax, especially when users pay by means of credit cards or by using the virtual purse.

1.2 Wealth factors

In terms of *wealth*, *inheritance* or *gift* tax, the taxpayer could consider a strategy whereby he invests his funds in goods which are not estimated by the tax authorities at market value : works of art (often unique pieces) such as paintings, jewellery, rugs, antique furniture. Similarly, stamp or old coin collections are usually sold at prices which differ greatly. Race horses and other special investments are also extremely difficult to assess.

It goes without saying that the motives for choosing this type of investment should only exceptionally be based on tax considerations, as they entail high risk of capital loss. The interest rate potentially yielded by the amounts invested in such goods should also be calculated. A comparison should be made with similar high risk investments, e.g. shares in emerging markets). Finally, brokerage fees, transportation, warehousing and insurance costs should also be taken into account.

In order for the investment to be advantageous in terms of *wealth tax*, the value of the goods should increase with time without the tax authorities raising their estimate in the same proportion.

With regards to income tax, the capital gains tax resulting from a later sale of the goods may well cancel any tax advantage. This happens when gains accumulated over a number of years suddenly become taxed at a high progressive rate. Tax treatment is questionable when gains are not weighted by the rate of inflation for the corresponding period, since the tax authorities would then levy tax on nominal and not on real gains. In several jurisdictions, such practice is only considered when gains are made in the context of commercial wealth. True love of art is therefore a vital condition for any such planning.

In terms of real estate in *Switzerland* and some other countries, the estimated rental value of a property occupied by the owner himself became a basis for taxation a long time ago. This is how for instance, in *France*, at the end of the 18th century, the Constitutional parliament insisted that this was the least imperfect basis for assessment, since individuals are usually housed according to their means.

In *Switzerland*, the value of a property occupied by the owner often determines the assessment of the notional rental income which is added to his income. This is justified by a wish to put owner and tenant on an equal footing. Finally, when it comes to agricultural or forestry land, it becomes extremely difficult to determine a fair value in view of the fact that their existence often depends on public policy. Highly conservative assessment methods are therefore used, based mainly on the yield value.

2. Companies

Assessing assets in a balance sheet is closely linked to taxation in time (e.g. selling hidden reserves in times of low profits and creating them when business flourishes) or in space (e.g. choosing the location of a branch or a subsidiary on the basis of the assessment rules in force in the jurisdiction in question). For further details, please refer to the relevant chapters.

In many countries, tax authorities use the balance on the profit and loss account to determine the basis of taxation, taking into account the reported balance of the preceding exercise. Therefore, commercial balance sheet and profit and loss accounts are the standard determining factors, at least when expenses are justified by commercial practice. The tax authorities will only waive this principle when amortisation and provisions, although authorised by commercial practice, appear exaggerated from a tax point of view.

Invested capital, discount charges and non repayable services do not represent a profit. Hidden reserves are only taxed upon realisation.

In several jurisdictions and especially in *Switzerland*, the legal structure of a business influences its asset value. So for example, the value of the business is represented by securities or shares. In principle, the Swiss tax authorities first proper balance its yield value (twice) and its intrinsic value (once). Secondly, in the case of minority shareholding, they admit a 35% forfeitry reduction on the resulting value. By way of comparison, no reduction is granted on shares in a partnership.

Conclusion

The taxpayer will endeavour, not only to benefit from tax advantages on existing assets but also to create new tax advantageous situations by investing into assets benefiting from favourable rules of assessments. However, the main objective should not be to save taxes.